United States Court of Appeals

for the Second Circuit

APPELLEE'S BRIEF

Signed

75-6131

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

THE AETNA CASUALTY AND SURETY COMPANY,

Plaintiff-Appellant

v.

UNITED STATES OF AMERICA,

Defendant-Appellee

ON APPEAL FROM THE JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF CONNECTICUT

UNITED STATES COURT OF APPEALS FILED APR 16 1976 A. DANIEL FUSARO, CLERK SECOND CIRCUIT

BRIEF FOR THE APPELLEE

SCOTT P. CRAMPTON,
Assistant Attorney General,

GILBERT E. ANDREWS,
ERNEST J. BROWN,
GEORGE G. WOLF,
Attorneys,
Tax Division,
Department of Justice,
Washington, D.C. 20530.

Of Counsel:

PETER C. DORSEY,
United States Attorney.

2

TABLE OF CONTENTS

CITATIONS

Cases:

Cases (continued): Page

Statutes:

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 75-6131

THE AETNA CASUALTY AND SURETY COMPANY,

Plaintiff-Appellant

v.

UNITED STATES OF AMERICA,

Defendant-Appellee

ON APPEAL FROM THE JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF CONNECTICUT

BRIEF FOR THE APPELLEE

STATEMENT OF THE ISSUE PRESENTED

Whether the District Court correctly held that under Section 381(b)(3) of the Internal Revenue Code of 1954, The Aetna Casualty and Surety Company is not entitled to carry back to a taxable year of its predecessor corporation its net operating losses incurred in taxable years subsequent to its reorganization.

STATEMENT OF THE CASE

This is a federal income tax case and is an appeal by The Aetna Casualty and Surety Company (New Aetna)[1/] from a judgment of the United States District Court for the District of Connecticut entered on December 10, 1975. (R. 144.)[2/] The memorandum of decision of the District Court (Honorable M. Joseph Blumenfeld) (R. 108-143), filed on October 15, 1975, is reported at 403 F. Supp. 498. A notice of appeal was timely filed by New Aetna on January 28, 1976. (R. 145.)[3/] Jurisdiction is conferred upon this Court by 28 U.S.C., Section 1291.

The relevant facts of this case, as found by the District Court or as stipulated or otherwise established without dispute in the record, may be summarized as follows:

The issues presented in this case are grounded on the merger of The Aetna Casualty and Surety Company (Old Aetna) into Farmington Valley Insurance Company (Farmington Valley)

1/ The issue in this case relates to the reorganization of The Aetna Casualty and Surety Company. The denominations New Aetna and Old Aetna will be explained in the text below.

2/ "R." references are to the separately bound joint appendix.

3/ The notice of appeal filed on January 28, 1976, was denominated an "Amended Notice Of Appeal." (R. 145.) An earlier notice of appeal, filed December 12, 1975 (R. 5), had improperly designated the order appealed from as the District Court's order of October 15, 1975, granting the Government's motion for summary judgment. (See, Notice of Appeal.)

on December 29, 1964. Prior to December 29, 1964, Old Aetna was a Connecticut company that wrote and sold liability, fire, theft, property damage, and surety insurance. Immediately prior to the merger, Old Aetna had outstanding 7,000,000 shares of $3.50 par value voting common stock. (R. 14, 24, 109.) Of these 7,000,000 shares, 4,312,535 shares (61.61 percent), all of which were acquired prior to 1957, were owned by Aetna Life Insurance Company (Aetna Life). The remaining 2,687,465 shares of Old Aetna outstanding (38.39 percent) were owned by 3,952 other shareholders. (R. 15.)

Aetna Life is a Connecticut company that writes and sells life, accident, and health insurance. (R. 14, 108.) Immediately prior to December 29, 1964, and the other transactions to be described below, Aetna Life had outstanding 8,000,000 shares of $5 par value voting common stock. (R. 24.)

The relationship between Aetna Life and its less-than-wholly-owned subsidiary, Old Aetna, presented several problems to the Aetnas, including corporate, accounting, and federal income tax problems, which indicated the desirability of rearranging that relationship. First, the existence of the minority interest in Old Aetna often impeded the directors and senior officers of Aetna Life and Old Aetna, who were identical for several years prior to December 29, 1964 (R. 19),

from viewing the Aetnas as a unit. That is, in making business decisions which affected the organization as a whole, substantial consideration had to be given to the directors' and officers' respective fiduciary duties to divergent groups of shareholders (R. 57, 60-61). This was manifested in several areas, primarily in the offering of insurance "packages" (R. 66) or "full-line insurance" (R. 25) where Aetna Life and Old Aetna wrote different aspects of the coverage. In many such circumstances, while the sale of the insurance package was profitable to the organization as a whole, various components of the package which were being written by one company or the other could not be justified on an individual basis. For example, in developing multiple line insurance coverage for doctors, it was thought desirable to include malpractice insurance, which was written by Old Aetna. While the package as a whole was profitable, the high risk and marginal profits of malpractice coverage made that particular coverage difficult to justify on an individual basis. (R. 65-66.) Similar problems were encountered in the offering of multiple line aviation insurance. (R. 71-72.)

Divergent fiduciary duties were also presented in several areas regarding personnel, including the shifting of better personnel from one company to the other to handle more difficult responsibilities (R. 62-63), the use by one company of the personnel of the other (R. 62), and the acceptance by one company of marginal insurance written by agents of the other company (R. 72-74). Other problems of a similar nature

were presented with respect to the financial relationship between the two companies, including the shifting of large amounts of surplus from Aetna Life to Old Aetna to meet the requirements of local insurance regulations (R. 74-75), and the maintenance of a uniform dividend policy (R. 76). All of these corporate problems would be eliminated if an identity of shareholder interest with respect to both Aetna Life and Old Aetna could be established.

Second, Aetna Life and Old Aetna shared the use of accounting facilities, personnel operations, a legal department, purchasing and supply operations, internal auditing staff, electronic data processing equipment, a field claims department, and the same building for their home office. (R. 19.) This necessitated the use of elaborate cost allocation systems in order fairly to allocate the cost of these functions between Aetna Life and Old Aetna. (R. 61.) While not eliminating cost allocation entirely, an identity of shareholder interest with respect to Aetna Life and Old Aetna would reduce the problems in this area. (R. 61.)

Third, Aetna Life's holding of Old Aetna's stock produced adverse federal income tax consequences for Aetna Life. (R. 109.) Effective with the Life Insurance Company Income Tax Act of 1959, P.L. 86-69, 73 Stat. 112, the federal income tax liability of life insurance companies such as Aetna Life was determined in part by the amount of assets held by the company. That is,

in general, the larger a company's assets, the greater the fraction of its income that is subject to tax.[4/] The Old Aetna stock held by Aetna Life was included in Aetna Life's assets for this purpose. (R. 109.)

Consequently, Aetna Life wished to remove the Old Aetna stock from its asset base. (R. 109.) However, merely distributing the Old Aetna stock to Aetna Life shareholders would produce a variety of undesirable consequences. First, such a distribution would compel a subtraction from Aetna Life's "shareholders surplus account" under Sections 815(a)(1) and (b)(3) of the Internal Revenue Code of 1954 (26 U.S.C.), which amount would constitute taxable income to Aetna Life under Section 802(b)(3) of the Code. This is part of the so-called Phase III computation for determining the income tax liability of life insurance companies. Second, the distribution of the

4/ The role played by a life insurance company's assets in determining its income tax liability is complex, but is generally as follows: Section 802(a) of the Internal Revenue Code of 1954 (26 U.S.C.) imposes a tax on "life insurance company taxable income" in accordance with the normal corporate tax and surtax of Section 11. Section 802(b)(1) defines "life insurance company taxable income" to include, in specified circumstances, "taxable investment income," (the so-called Phase I computation). Section 804 defines "taxable investment income" generally in terms of "investment yield," but Section 804(a)(1) excludes from this computation the "policyholders' share" of "investment yield," which is determined by a fraction the numerator of which is "policy and other contract liability requirements." Section 805(a)(1) defines "policy and other contract liability requirements" to include the adjusted life insurance reserves multiplied by the "adjusted reserves rate." Under Section 805(b)(1), the "adjusted reserves rate" is determined by the "current earnings rate" under either Section 805(b)(2) or Section 805(b)(3). Section 805(b)(2) defines "current earnings rate" as a fraction the denominator of which is the company's assets, as defined in Section 805(b)(4). Thus, the larger a company's assets, the smaller the fraction under Section 805(b), which eventually produces a smaller exclusion for the "policyholders' share"

(continued)

stock of a less-than-eighty-percent-controlled subsidiary, as was involved in this case, would not meet the non-recognition of income requirements of Section 355 of the Code,[5/] and, as a result, would constitute taxable dividend income to Aetna Life's shareholders under Sections 301 and 317. Third, merely distributing the Old Aetna stock to Aetna Life shareholders would, in all likelihood, destroy the organizational unity which the Aetnas sought to achieve.

While the second and third objections described in the preceding paragraph could be obviated under existing provisions of law, there was, prior to 1962, no method by which Aetna Life could distribute the Old Aetna stock to Aetna Life shareholders and yet avoid the distribution tax under the Phase III computation. In 1962, however, Congress passed the Act of October 23, 1962, P.L. 87-585, 76 Stat. 1134. Section 3(e) of that Act amended Section 815(a) of the Internal Revenue Code of 1954, effective for taxable years beginning after December 31, 1961, to exclude from the definition of "distribution" to shareholders (and, hence, from the Phase III computation) "any distribution before January 1, 1964, of the stock of a controlled corporation to

4/ (cont.) of "investment yield" under Section 804(a)(1). For a more detailed discussion, see 8 Mertens, The Law of Federal Income Taxation (Rev.), § 44A.04 et seq.

5/ In particular, see the control requirement in Section 355(a)(1)(A) and the definition of "control" in Section 368(c) of the Code.

which section 355 applies, if such controlled corporation is an insurance company subject to the tax imposed by section 831 and control has been acquired prior to January 1, 1963, in a transaction qualifying as a reorganization under section 368(a)(1)(B)." Aetna Life did not take advantage of this provision.

Aetna Life did, however, lobby for a further relaxation of the distribution rules. (R. 92-94, 110.) In 1964, Congress responded with passage of the Act of September 2, 1964, P.L. 88-571, 78 Stat. 857. Section 4(a)(2) of that Act amended Section 815 of the Code, effective for taxable years beginning after December 31, 1963, by adding thereto a new subsection (f) to exclude enumerated transactions from the definition of "distribution" to shareholders for purposes of the Phase III computation. Most of these exclusions were merely restatements of prior law. Pertinent to this case, however, Section 815(f)(3) expanded the ameliorative provision for the distribution of stock of a controlled insurance subsidiary. In general, such a distribution would not be part of the Phase III computation if the distribution was of stock of a controlled corporation to which Section 355 applied (dealing with nonrecognition of gain to shareholders) and the requisite 80 percent control (see Sec. 368(c)) of the subsidiary corporation had been acquired by the distributing corporation in the requisite manner, as further specified in the statute. Under Section 815(f)(3)(A), an otherwise qualifying distribution would qualify

if control had been acquired in any manner prior to January 1, 1958. If control was acquired on or after that date, the statute provided two permissible methods of acquiring control. Under Section 815(f)(3)(B)(i), control could be acquired in a transaction qualifying as a reorganization under Code Section 368(a)(1)(B) (dealing with stock for stock exchanges) provided that the distributing or parent corporation had at all times since December 31, 1957, owned stock of the controlled corporation representing at least 50-percent control. Under Section 815(f)(3)(B)(ii), control of the insurance subsidiary could be acquired by use of a wholly owned shell subsidiary. Under this provision, an otherwise quailfying distribution will qualify if control of the shell subsidiary (which at all times since its organization has been wholly owned by the distributing or parent corporation), was acquired solely in exchange for stock of the distributing or parent corporation, and the shell subsidiary immediately exchanges its parent corporation's stock in a transaction qualifying as a reorganization under Section 368(a)(1)(A) (statutory merger or consolidation) or Section 368(a)(1)(C) (generally, stock for assets exchanges), provided that the distributing or parent corporation has at all times since December 31, 1957, owned stock representing at least 50-percent control of the insurance subsidiary corporation, the assets of which are transferred to the controlled shell

corporation in the Section 368(a)(1)(A) or (C) reorganization. 6/

With the addition of Section 815(f)(3) to the Internal Revenue Code of 1954 by the Act of September 2, 1964, the stage was set for the reorganization of Old Aetna and its relationship to Aetna Life. On September 3, 1964, the boards of directors of Aetna Life and Old Aetna met and adopted resolutions approving a plan of recapitalization and reorganization for "the closer affiliation of the two companies." (Exs. A, B.) Subject to the approval of the shareholders of each company, approval by the Insurance Commissioner of Connecticut, and favorable rulings from the Internal Revenue Service, the steps of the plan of recapitalization and reorganization were as follows (Exs, A, B):

> (1) an increase in Aetna Life's capital, a 2 for 1 split in Aetna Life stock, and a twenty-five-percent stock dividend on Aetna Life's stock;
>
> (2) the organization by Aetna Life of a new corporation (referred to as New Company) and the issuance to New Company of shares of Aetna Life stock in exchange for all of the shares of New Company;

6/ The text of Section 815(f)(3) is set out in the Appendix, *Infra*. Greater attention will be paid to the details of this provision in the argument portion of this brief. We might mention in passing at this point that the significance of the January 1, 1958 date in the statute relates to the time that a life insurance company's federal income tax liability began to be affected by adjustments to shareholders' surplus accounts. See S. Rep. No. 1428, 88th Cong., 2d Sess., pp. 1-2, 11 (1964-2 Cum. Bull. 844-845, 851).

(3) the merger of Old Aetna into New Company on terms which (after giving effect to the proposed Aetna Life stock split and stock dividend) would provide for the exchange between New Company and the shareholders of Old Aetna of 1.9 shares of Aetna Life stock for each share of Old Aetna stock; and

(4) the distribution by Aetna Life, prior to the close of business on December 31, 1964, of all of the shares of New Company to a trust for the benefit of all Aetna Life shareholders, such shares to be "stapled" to the shares of Aetna Life so that thereafter they would trade as a unit.

These resolutions further provided that Aetna Life and Old Aetna would send a joint letter to their respective shareholders with respect to the proposed plan and that, if the plan were completed as anticipated, it was the intention of the respective boards to declare a quarterly cash dividend from each company that, when combined, would equal 20¢ per share. (Exs. A, B.)

By letters dated September 9, 1964 (R. 23-34), September 22, 1964 (R. 35), and September 28, 1964 (R. 36-37), from Adrian W. DeWind of the law firm of Paul, Weiss, Rifkind, Wharton & Garrison[7/] to Bertrand M. Harding, Acting Commissioner of Internal Revenue, Aetna Life and Old Aetna sought rulings from the Internal Revenue Service as to the tax consequences of their proposed plan of recapitalization and reorganization. After

7/ Paul, Weiss is also the law firm which conducted lobbying activity in connection with the passage of the Act of September 2, 1964, on behalf of Aetna Life. (R. 93.)

outlining the facts, explaining the business purposes of the proposed transaction, especially the Aetnas' desire more fully to integrate their operations (R. 25-26), and giving the details of the proposed recapitalization and reorganization (R. 27-29), the following rulings, <u>inter alia</u>, were requested (R. 30-31):

1. The two-for-one split of Aetna Life common stock would constitute a recapitalization under Code Section 368(a)(1)(E);

2. The 25-percent stock dividend on Aetna Life stock would be nontaxable to Aetna Life's shareholders under Code Section 305(a);

3. The formation of the new company (referred to as New Corporation) and the exchange of Aetna Life stock for all of the stock of New Corporation would constitute a nontaxable transaction under Code Section 351(a);

4. The merger of Old Aetna into New Corporation and the transfer of the Aetna Life stock held by New Corporation to the shareholders of Old Aetna would constitute a reorganization within the meaning of Code Section 368(a)(1)(C);

5. The receipt by the shareholders of Old Aetna of the Aetna Life stock would be nontaxable to the shareholders of Old Aetna under Code Section 354;

6. New Corporation would not recognize gain or loss on the reorganization under Code Section 361 and would succeed to the basis of Old Aetna for the assets acquired from Old Aetna as a result of the reorganization under Code Section 362; and

7. The transfer by Aetna Life to a trustee for the benefit of its shareholders of the stock of New Corporation would constitute a distribution within the meaning of Code Section 355 and would be a nontaxable transaction to both Aetna Life and its shareholders under Code Sections 311 and 355.

Mr. DeWind further explained that "time is of the essence" (R. 37) for two reasons. First, due to the nature of the income tax laws and Aetna Life's holding of Old Aetna stock, it was imperative that the reorganization of Old Aetna and Aetna Life's distribution of New Corporation's stock be completed by December 31, 1964, if Aetna Life were to get the advantage of new Section 815(f)(3) in 1964. (R. 32.) See, Sec. 805(b)(2)(B), Internal Revenue Code of 1954 (26 U.S.C.). Second, to "prevent gyrations in the market values" of the two companies' stocks due to speculation, the boards of the two companies had immediately after the passage of the Act of September 2, 1964, established and announced the proposed plan of reorganizations and the exchange ratio (1.9 to 1) for the exchange of Aetna Life stock for Old Aetna stock. (R. 32-33.) To maintain the stated ratio, the plan of reorganization would have to be completed "promptly." (R. 33.)

On October 21, 1964, the Insurance Commissioner of Connecticut issued a finding and final order by which he approved of the proposed recapitalization of Aetna Life and reorganization of Old Aetna. (R. 38-39.) By letter dated October 23, 1964, from John W. D. Littleton, Director, Tax

Rulings Division, Internal Revenue Service, to Mr. DeWind, the Internal Revenue Service issued the requested favorable rulings with respect to the federal tax consequences of the proposed recapitalization of Aetna Life and reorganization of Old Aetna. (R. 40-46.)

By letters dated October 26, 1964, the management of each company mailed to their respective shareholders a notice of shareholders' meetings to be held November 24, 1964, to act upon the proposed recapitalization of Aetna Life and reorganization of Old Aetna. (Exs. F, G.) Each shareholder also received a proxy statement in which the proposed recapitalization and reorganization were explained, together with the reasons therefor and other pertinent information. (Ex. H.) The management of each company urged approval of the plan. (Ex. H.) The plan of recapitalization and reorganization were adopted and approved by the shareholders of Aetna Life and Old Aetna on November 24, 1964. (R. 17.)

Pursuant to the plan of recapitalization and reorganization, the following occurred:

1. The par value of Aetna Life's voting common stock was reduced from $5.00 to $2.50 (R. 38-39);

2. A two-for-one split of Aetna Life common stock and a 25 percent stock dividend was declared on such stock, resulting in the increase in the number of shares then outstanding from 8,000,[illegible] to 20,000,000 (R. 17, 30, 38-39);

3. Aetna Life organized Farmington Valley Insurance Company (Farmington Valley) (R. 17) with authorized capital stock of 1,000 shares of $500 par value per share (R. 38), and exchanged an additional 13,300,000 shares of Aetna Life voting common stock for all of the stock of Farmington Valley (R. 17);

4. On December 29, 1964, Old Aetna merged into Farmington Valley pursuant to Connecticut law, and Farmington Valley changed its name to The Aetna Casualty and Surety Company (New Aetna) (R. 17);

5. On December 29, 1964, New Aetna exchanged the 13,300,000 shares of voting common stock of Aetna Life held by New Aetna for the 7,000,000 outstanding shares of Old Aetna at the rate of 1.9 shares of Aetna Life stock for each share of Old Aetna stock,[8/] the stock of Old Aetna was cancelled, and the Aetna Life stock received by Aetna Life on the exchange was immediately retired (R. 17-18); and

6. On December 30, 1964, Aetna Life distributed all of the stock of New Aetna to a trust (referred to as "the stapled trust") for the benefit of all Aetna Life shareholders (R. 18, Ex. I).

As a result of the merger on December 29, 1964, the existence of Old Aetna merged with New Aetna, and Old Aetna ceased to exist. (R. 19.) New Aetna, which had theretofor conducted no business (R. 18), became the owner of all the property, assets, debts

8/ None of the shareholders of Old Aetna exercised their statutory rights of appraisal. (R. 18.)

due to, rights, powers, privileges, and franchises of Old Aetna, and became subject to all of the liabilities, debts, and duties of Old Aetna (R. 18-19). New Aetna assumed the business of Old Aetna and operated it in essentially the same manner as had Old Aetna. (R. 19.)

Old Aetna and New Aetna had income or net operating losses for the years 1963, 1964, and 1965 as follows (R. 20-21):

	Old Aetna	New Aetna
1963	$8,525,816.75 (after application of the net operating loss carry-back for the period January 1, 1964, to December 29, 1964)	
January 1, 1964, to December 29, 1964	($7,213,547 (carried back to 1963)	
December 30, 1964, to December 31, 1964		($39,597)
1965		($11,554,725)

Federal income taxes with respect to Old Aetna's income for the taxable year 1963 were paid in the amount of $4,071,655.21, plus deficiency interest of $395,975.38. (R. 38.) These taxes were paid with respect to Old Aetna's income for 1963 after application of Old Aetna's net operating loss carryback for the period January 1, 1964, to December 29, 1964. (R. 21.) By timely claims for refund filed by New Aetna, New Aetna sought to carry back its net operating losses for the periods December 30, 1964, to December 31, 1964, and 1965 to Old Aetna's taxable year 1963 (R. 21), and sought a consequent refund of the income taxes and deficiency interest paid with respect to that year ($4,467,630.59), plus statutory interest (R. 22). These

claims were not allowed by the Internal Revenue Service (R. 21), whereupon New Aetna brought this suit for refund by filing its complaint in the court below on August 14, 1973 (R. 6-12).

This case was presented to the lower court for disposition on the parties' cross-motions for summary judgment. (R. 105, 106-107.) The Government urged that New Aetna was not entitled to carry back its net operating losses to a taxable year of Old Aetna pursuant to Section 381(b)(3) of the Internal Revenue Code of 1954. (R. 114-116.) New Aetna argued that it was not subject to the proscription of Section 381(b)(3) because (1) the transaction whereby Old Aetna was merged into New Aetna was not a reorganization (R. 117), (2) that the transaction constituted a reorganization under Section 368(a)(1)(B) (R. 120), or (3) that the transaction constituted a reorganization under Section 368(a)(1)(F) (R. 127). In ruling in favor of the Government, the District Court held (1) that this transaction did constitute a reorganization (R. 120), (2) that the merger of Old Aetna into New Aetna precluded the transaction from being a "B" reorganization (R. 126), and (3) the changes in shareholder interests effected by the reorganization precluded the transaction from being an "F" reorganization (R. 142). Consequently, Section 381(b)(3) applied and prohibited the net operating loss carrybacks. (R. 142.) Judgment was entered in favor of the United States accordingly. (R. 144.) New Aetna appeals.

SUMMARY OF ARGUMENT

1. The issue in this federal income tax case is the effect that Old Aetna's reorganization into New Aetna has upon New Aetna's net operating loss deduction. The resolution of this issue depends upon the interrelationships among Section 172 of the Internal Revenue Code of 1954, dealing with net operating losses, Section 368, which provides definitions relating to corporate reorganizations, and Section 381, which provides rules for the transfer of specified tax attributes following certain types of reorganizations. Normally, under Section 172, a corporation that incurs a net operating loss for a taxable year is allowed to carry such loss back for three years and forward for five years to offset the loss against its income for the earlier and later periods. This rule may be altered, however, if one or more of the carryback or carryforward years is a taxable year of a corporation other than the one which incurred the net operating loss due to an intervening reorganization. Section 381 provides rules that govern the operation of net operating loss carrybacks and carryforwards, as well as numerous other tax attributes, in this situation.

Section 381 depends for its operation upon a particular type of corporate reorganization. It permits loss carryforwards after reorganizations defined in Section 368(a)(1)(A), i.e., a statutory merger or consolidation, in Section 368(a)(1)(C), i.e. acquisition by one corporation of substantially all of the assets of another corporation solely in exchange for the acquiring

corporation's or its parent's voting stock, in Section 368(a)(1)(D), (with limitation), i.e., a transfer by one corporation of substantially all of its assets to another corporation under common control (plus certain additional requirements), and in Section 368(a)(1)(F), i.e., a "mere change identity, form, or place of organization." Except in the case of a reorganization defined in Section 368(a)(1)(F), Section 381(b)(3) provides that, following one of these types of asset acquisition reorganizations, the corporation acquiring assets is not allowed to carry back a net operating loss for a post-acquisition year to a taxable year of the corporation whose assets were acquired.

Applying these provisions to the facts of this case, the initial determination is whether Old Aetna's merger into New Aetna constituted one of the types of asset acquisition reorganizations to which Section 381 is made applicable. Here, New Aetna acquired all of the assets of Old Aetna solely in exchange for stock of Aetna Life--a C reorganization. Thus, Section 381(b)(3)'s restriction on net operating loss carrybacks is applicable, and New Aetna is not allowed to carry back its net operating losses for post-acquisition years to a pre-acquisition taxable year of Old Aetna. We submit the District Court correctly so held.

2. New Aetna's argument that Section 381(b)(3)'s restriction should not apply in this case, because its sole purpose was to avoid the problems of intercorporate accounting which are not present in this case, is unmeritorious for several reasons.

First, the expressed legislative purpose in enacting Section 381 in 1954 was to provide definite and rational rules governing the treatment of several major tax attributes, including the net operating loss deduction, following corporate reorganizations. Theretofore, all such questions were determined on a case by case basis, and Congress perceived that their resolution often produced confusing and conflicting results. New Aetna's attempt to interject extra-statutory considerations into the provisions of Section 381 would wholly frustrate Congress's purpose in this area.

While there is evidence that Congress was mindful of accounting problems with respect to the net operating loss deduction, their avoidance was not the sole consideration. On the contrary, the statute does allow certain net operating loss carrybacks and most net operating loss carryforwards without requiring allocation. Thus, the essential premise of New Aetna's argument, that the sole purpose in enacting Section 381(b)(3) was to avoid accounting problems, is simply wrong.

On the other hand, examination of those types of reorganization transactions to which the restriction does not apply leads to the conclusion that Congress intended to allow the carryback where either the corporate entity or the set of economic interests that incurs the net operating loss is the same entity or set of economic interests that earlier incurred and bore the tax, a refund of which will be generated by the net operating loss carryback. Thus, in stock-for-stock B

reorganizations and in recapitalizations (E reorganizations), the corporate identity of the taxpayer remains unchanged, and a post-reorganization net operating loss may be carried back against its own prior income without reference to Section 381. In F reorganizations (mere change in identity, form, etc.), while the legal identity of the corporation is changed, its economic identity (with respect to its business operations as well as with respect to its shareholders) remains the same. Here again, the set of economic interests that incurs the loss may carry back such loss against its own prior income.

Where, however, a new corporation or a new set of economic interests incurs the loss, Congress has determined that that loss may not be carried back against the income of a different corporation or a different set of economic interests, and has not allowed a refund of taxes that were incurred and borne by the latter group. It is in this circumstance that this case is situated. Here, New Aetna, owned in 1965 by all of Aetna Life's shareholders, is seeking a $4,467,000 refund of taxes that were incurred by Old Aetna and borne by Old Aetna's then shareholders. Congress has determined not to allow this.

Moreover, there is nothing in either the language or the history of Section 381(b)(3) which indicates that Congress intended that it should be selectively applied. On the contrary, the statute admits of no exception. So also in the committee reports, the language employed indicates no hesitancy whatsoever in providing that the statute is to apply regardless of the circumstances of the particular case. This is in accord with

Congress's paramount purpose of providing definite rules to govern the resolution of these sometimes complex questions. Both this Court and the Supreme Court have previously disapproved the notion that precise statutory language could be disregarded where there was no indication from Congress that it should be applied on a case-by-case basis.

Finally, the evolution of Section 381(b)(3) in Congress further establishes that it is not to be selectively applied. As originally passed by the House, the statute provided a complete prohibition on net operating loss carrybacks following asset acquisition reorganizations. Upon presentation to the Senate Finance Committee of various circumstances where this result was unduly harsh, the Senate added the exception for F reorganizations (mere change in identity, form, etc.), but left otherwise untouched the complete prohibition of net operating loss carrybacks in this area. New Aetna, however, cannot qualify for the limited exception added in the Senate.

2. New Aetna's argument that this transaction qualified as a stock-for-stock B reorganization, and is thus outside the scope of Section 381, is also unmeritorious for several reasons. There is an essential distinction between a stock-for-stock B reorganization and a stock-for-assets C reorganization. In a B, the reorganization occurs at the shareholder level. That is, the acquiring corporation acquires the stock of the target corporation, usually directly from the target corporation's shareholders. The target corporation itself is left untouched. Here, the Aetna Life stock was specifically exchanged by New

Aetna for the assets of Old Aetna, and upon the merger, the identity of Old Aetna was extinguished. This simply does not constitute a stock-for-stock B reorganization.

Moreover, the Aetnas' choice of a stock-for-assets C reorganization wasthe result of several significant business and tax-related reasons. By use of this method of reorganization, the Aetnas achieved: (a) the creation of a complete identity of shareholder interest with respect to both Aetna Life and New Aetna, (b) the removal of the Old Aetna stock from Aetna Life's asset base for purposes of its life insurance company income tax liability, (c) these two objectives were accomplished completely tax free,and (d) the Aetnas were able to control the entire series of steps in this transaction in order to ensure that the stated exchange ratio would be maintained and that the transaction would be completed by the end of the taxable year. Many of these objectives could not have been accomplished with assurance if Aetna Life had merely attempted to acquire the outstanding shares of Old Aetna by means of a tender offer.

Furthermore, the history and language of Section 815(f)(3)(B), pursuant to which this transaction was instituted, demonstrate that this transaction was not a B reorganization. Thus, Aetna Life did not attempt a B reorganization when the life insurance company income tax provisions allowed such transactions in 1962. Instead, it sought and received Congressional approval for C reorganizations to comply with the requirements of the Phase III rules. The transaction undertaken in this

case exactly conformed to the intricate requirements for a qualifying C reorganization as specified in Section 815(f)(3)(B)(ii). Thus, both Congress and the Aetnas fully understood the distinctions between a B and a C reorganization. For several significant reasons, the Aetnas chose the latter.

New Aetna's reliance upon Casco Products Corp. v. Commissioner, 49 T.C. 32 (1967), is misplaced. In that case, a divided Tax Court erroneously ignored the fact that a reorganization had occurred, finding it to have been a "legal technique" to acquire the shares of a dissident minority. Where the form of a transaction matches its substance, however, as in this case, the incidence of federal taxation depends very much upon which "legal technique" is employed. In any event, there is nothing in Casco Products which even remotely supports New Aetna's argument that this transaction was a stock-for-stock B reorganization.

Finally, the revenue rulings cited by New Aetna, far from establishing its contention that the same transaction can be both a B and a C reorganization, firmly establish that it cannot. As these revenue rulings make clear, a critical distinction is that in a B reorganization the identity of the target corporation remains intact, while in a C reorganization it does not. In this case, since the identity of Old Aetna was extinguished upon its merger into New Aetna, this transaction cannot be a B reorganization.

The judgment of the District Court is correct and should be affirmed.

ARGUMENT

PURSUANT TO SECTION 381(b)(3) OF THE INTERNAL REVENUE CODE OF 1954, NEW AETNA IS NOT ENTITLED TO CARRY BACK ITS NET OPERATING LOSSES TO A TAXABLE YEAR OF OLD AETNA

A. Introduction

Following certain types of tax free corporate reorganizations, questions are often presented as to the extent to which one corporation that is a party to the reorganization may, or in fact must, take into account the "tax history" of another corporation that is a party to the reorganition. These questions spring primarily from the notion, firmly embodied in our revenue laws, that corporations are independent legal and taxpaying entities. See, Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders (3d ed.), p. 16-2. Thus, ordinarily, one corporation is not allowed to deduct an expense which is or was properly incurred by another and different corporation. Under certain circumstances, however, one corporation may properly be said to have assumed an expense which was originally incurred by another corporation, and its payment will give rise to a deduction. See, e.g. Helvering v. Metropolitan Edison Co., 306 U.S. 522 (1939). Similarly, under some circumstances, when one corporation acquires another corporation, various aspects of the acquired corporation's "tax history," such as its earnings and profits account, should properly be reflected in the accounts of the acquiring corporation in order to prevent tax avoidance. See, e.g. Commissioner v. Sansome, 60 F. 2d 931 (C.A. 2, 1932). The resolution of these

questions depends upon the interaction of these provisions of the revenue laws governing the particular item or tax attribute involved and the provisions dealing with corporate reorganizations. In addition, with respect to certain such questions, Congress has provided statutory rules governing their resolution. See, Bittker and Eustice, supra, pp. 16-2--16-3.

This case presents one such question--namely, the effect which Old Aetna's merger into New Aetna has upon New Aetna's net operating loss deduction. The resolution of the issues presented by this question involves the interaction of the provisions of the Internal Revenue Code of 1954 (26 U.S.C.) dealing with the net operating loss deduction (Section 172), the definitions of the several types of corporate reorganizations (Section 368), and, since this is one of the areas where Congress has provided specific rules, the statutory provisions governing the transfer of corporate tax attributes in Section 381.

Under Section 172 of the Code, when a taxpayer incurs a net operating loss for a taxable year, it is, to a limited extent, allowed to offset that loss against its income for some earlier and later years. That is, Section 172 provides an ameliorating mechanism for something like an averaging of income over business cycles, setting off "its lean years against its lush years." Libson Shops v. Koehler, 353 U.S. 382, 386 (1957). This result is achieved under the statute by allowing the taxpayer, in general, to carry its net operating loss back for three years and then forward for five years. Sec. 172(b). Although many thorny questions can

arise as to operation of Section 172,[9] calculations as to the amount of New Aetna's net operating losses or the amount of the refund that it here seeks are not in dispute. (R. 22.) Rather, the issue here is solely whether the three year carryback under Section 172(b) is altered by the fact that the carryback year involved (1963) is not a taxable year of New Aetna, which incurred the net operating losses, but a taxable year of Old Aetna. As we shall show, the circumstances as to Old Aetna's reorganization into New Aetna are critical to that determination.

Section 368(a)(1) of the Code, Appendix, _infra_, contains descriptions of six types of corporate transactions which the Code defines as "reorganizations." It is not itself an operative provision. Rather, Section 368 provides definitions of transactions for which other sections of the Code prescribe the tax effect. See, Bittker and Eustice, _supra_, p. 14-9. The six types of transactions are, generally: (A) a statutory merger or consolidation, (B) the acquisition by one corporation of a controlling interest in the stock of another corporation, solely in exchange for its own or its parent corporation's stock, (C) the acquisition by one corporation of substantially all of the assets of another corporation, solely in exchange for its own or its parent corporation's stock, (D) the transfer by one corporation of all or part of its assets to another corporation if the transferor corporation and/or its shareholders control

9/ See, e.g., _Foster Lumber Co._ v. _United States_, 500 F. 2d 1230 (C.A. 8, 1974), cert. granted, 420 U.S. 1003 (1975), and cf. _Mutual Assurance Society of Virginia Corp._ v. _Commissioner_, 505 F. 2d 128 (C.A. 4, 1974).

the transferee corporation and if the transferor corporation distributes to its shareholders any stock of the transferee corporation which it might hold, (E) a recapitalization, and (F) a "mere change in identity, form, or place of organization." 10/ These definitions have their roots in Sections 202(e) of the Revenue Act of 1921, c. 136, 42 Stat. 227, and 203(h)(1) of the Revenue Act of 1924, c. 234, 43 Stat. 253. While they have been the subject of modification and refinement over the years (especially by Section 112(g) of the Revenue Act of 1934, c. 277, 48 Stat. 680, and by the Internal Revenue Code of 1954), the modern tax law of corporate reorganization has developed on the basis of the six 1921 and 1924 definitions.

These six types of corporate reorganizations lend themselves to several taxonomies. See, e.g., Bittker and Eustice, *supra*, p. 14-15. For our purposes, however, they may be divided into two groups on the basis of one factor: those which involve the transfer of assets from one corporation to another, and those which do not. Thus, A reorganizations (mergers or consolidations), C reorganizations (stock for assets exchanges), D reorganizations (transfers of assets to a controlled corporation), and most F reorganizations (changes in identity, form, etc.) all involve at least

10/ These six types of reorganizations are generally referred to by the capital letter (A, B, etc.) designating each's particular subparagraph of Section 368(a)(1) and will be so referred to herein. Further refinements of these definitions are provided in Section 368(a)(2), to which we will make particular reference as they become pertinent. Finally, Section 368(b) defines the term, "party to a reorganization," and Section 368(c), Appendix, *infra*, defines "control," generally, as 80-percent control.

two corporations, with one acquiring the assets of the other in some manner. On the other hand, B reorganizations (stock for stock exchanges) and E reorganizations (recapitalizations) each involve transactions where a single corporation's relationship and identification with its assets remains unchanged. As we shall show immediately below, this distinction is crucial to the application of Section 381.

As we noted above, Congress has provided statutory rules governing the transfer of various tax attributes following various types of corporate reorganizations. One such statute is Section 381. First enacted with the Internal Revenue Code of 1954, Section 381, where applicable, provides for the treatment of some 23 tax attributes. These include such items as earnings and profits accounts (Sec. 381(c)(2)), methods of accounting (Sec. 381(c)(4)), and bond discount and premium (Sec. 381(c)(9)). Pertinent to this case, Section 381 also provides special rules governing net operating loss carrybacks (Sec. 381(b)(3)) and net operating loss carryforwards (Sec. 381(c)(1)).

Section 381 depends for its application, however, on a particular type of inter-corporate transaction, i.e., Section 381(a) makes the provision applicable "In the case of the acquisition of assets of a corporation by another corporation," if (Sec. 381(a)(2)) such acquisition occurs in a tax free A, C, or F reorganization, or in certain D reorganizations. Given the details of these provisions, the acquiring corporation must acquire substantially all of the assets of the transferor corporation.

The basis of distinction contained in the statute is apparent. A, C, D, and most F reorganizations involve at least two corporations, and their relationship to one set of assets (including business properties, capital accounts, etc.). Questions necessarily arise as to the extent, if any, that one corporation's relationship to the set of assets affects the other corporation's relationship to the same assets. The purpose of Section 381 is to answer many of these questions. H. Rep. No. 1337, 83d Cong., 2d Sess., p. 41 (3 U.S.C. Cong. & Adm. News (1954) 4017, 4066). On the other hand, B reorganizations (stock for stock exchanges) and E reorganizations (recapitalizations) involve changes at the shareholder level. The identity of the corporate taxpayer, and its relationship to its own assets, remains unchanged. There is, thus, no basis to question the corporation's continued treatment of its accounts as it had done prior to the reorganization,[11] and these types of transactions are not covered by Section 381.[12] H. Rep. No. 1337, *supra*, p. A135 (3 U.S.C. Cong. & Adm. News (1954), p. 4273).

This brings into focus the particular provision involved in this case. Section 381(b)(3), Appendix, *infra*, provides a specific rule for the treatment of a net operating loss carryback following one of the types of reorganizations enumerated

11/ Indeed, many provisions of the Code would preclude any such changes. See, e.g., Sec. 446(e) of the Internal Revenue Code of 1954 (26 U.S.C.).

12/ Of course, taxable transactions, such as the simple purchase of assets for cash, are wholly outside the scope of Section 381.

in Section 381(a). With an exception not pertinent here,[13/] the statute provides that "the corporation acquiring property * * * shall not be entitled to carry back a net operating loss * * * for a taxable year ending after the date of * * * transfer to a taxable year of the * * * transferor corporation."
Sec. 381(b)(3). Stated more simply, an acquiring corporation cannot offset post-affiliation losses against the pre-affiliation income of the transferor corporation. The acquiring corporation is allowed to carry back and offset its losses only against its own prior income.

Applying these provisions to the facts of this case, pursuant to the plan of reorganization, upon the merger of Old Aetna into New Aetna, New Aetna acquired all of assets of Old Aetna in exchange for voting stock of its parent, Aetna Life. (R. 17-19, 111-113.) Thus, this transaction constituted a C reorganization--in the words of the statute, the transaction was "the acquisition by one corporation [New Aetna], * * * in exchange solely for * * * a part of the voting stock of a corporation [Aetna Life] which is in control of * * * [New Aetna], of substantially all of the properties of another corporation [Old Aetna]." Sec.

13/ Section 381(b) does not apply to F reorganizations (mere changes in identity, form, etc.) for reasons which we will discuss later in this brief. New Aetna is no longer contending that this transaction constituted an F reorganization.

368(a)(1)(C).[14/] A C reorganization is one of the types of transactions to which Section 381 is made applicable by Section 381(a)(2). Consequently, under Section 381(b)(3), "The corporation [New Aetna] acquiring property in a * * * transfer described in subsection (a) [here, a C reorganization] shall not be entitled to carry back a net operating loss * * * for a taxable year ending after the date of * * * transfer [here, December 30-31, 1964, and 1965] to a taxable year [here, 1963] of the * * * transferor corporation [Old Aetna]." We submit, therefore, that the District Court correctly held (R. 142) that New Aetna is not entitled to carry back its net operating losses for its taxable years December 30-31, 1964, and 1965 to the taxable year 1963 of Old Aetna under the above provisions of law.

New Aetna, nevertheless, contends that it should be allowed this net operating loss carryback. It argues (Br. 10-21), first, that the restriction on net operating loss carrybacks of Section 381(b)(3) was not intended to apply to the type of transaction involved in this case. Alternatively, New Aetna argues (Br. 22-35)

14/ Being a statutory merger, the transaction would also constitute an A reorganization. However, prior to the addition of Section 368(a)(2)(D) and the amendment of Section 368(b) by the Act of October 22, 1968, P.L. 90-621, 82 Stat. 1310, it could not qualify as a tax-free A reorganization under Sections 354(a)(1) and 361(a) of the Code, Appendix, *infra*, because Aetna Life, whose stock was exchanged, was not a "party to * * * [the] reorganization." The distinctions between an A and a C reorganization, however, are not material to the issues presented in this case.

that this transaction constituted a B as well as a C reorganization and is thus outside of the proscription of Section 381(b)(3).[15/] We submit that both of these arguments are unmeritorious and should be rejected.

B. The restriction of Section 381(b)(3) applies to the reorganization transaction involved in this case

As discussed above, Section 381(b)(3) plainly disallows the net operating loss carryback which New Aetna seeks in this case. In an effort to avoid this result, New Aetna argues (Br. 12) that "The objective of the provision was solely and simply to avoid the problem of inter-company apportionment of income and loss in those cases where a transferor and an acquiring corporation are both potential users of the carryback." (Emphasis deleted.) Applying this asserted sole legislative purpose to this case, New Aetna urges (Br. 12-13) this Court to hold "either (a) that Section 381(b)(3) does not apply to single-company reorganizations in which a new, shell corporation merely succeeds another with no alteration of the operating business, or (b) that except in consolidations involving two (or more) operating companies, the reference to an acquiring 'corporation' in Section 381(b)(3) means an entity with at least one prior period of status as a taxpayer or with operating assets of its own." We submit that this argument, which was not addressed to the District Court, is erroneous in that its essential premise

15/ On appeal, New Aetna has abandoned the arguments it made below that this transaction was not a reorganization or was an F reorganization.

is not supported by the legislative history of Section 381(b)(3), that its conclusion is contrary to the plain language of the statute itself, and, consequently, that it should be rejected. Braunstein v. Commissioner, 374 U.S. 65 (1963), aff'g, 305 F. 2d 949 (C.A. 2, 1962). See also, Commissioner v. Adam, Meldrum & Anderson Co., 215 F. 2d 163, 166 (C.A. 2, 1954), cert. denied, 348 U.S. 913 (1955).

An examination of the pertinent legislative history of Section 381 discloses that the Congressional purpose in enacting the statute was not, as New Aetna contends, to avoid the minutiae of corporate tax accounting. Rather, the paramount Congressional purpose was to provide definite and rational rules for the transfer of corporate tax attributes following reorganizations--to remove the confusion of existing law, developing on a case-by-case basis (H. Rep. No. 1337, supra, p. 41:

> Present law makes no provision for the transfer from one corporation to another, in a tax-free merger or consolidation, of the major tax benefits, privileges, elective rights and obligations which were available to the predecessor. These include such items as loss carryovers, unamortized bond discount, installment sales reporting, LIFO inventory method, etc. The courts have held, in general, that such tax attributes of a corporation may be preserved only by continuing the corporation's identity. For example, the surviving corporation in a merger is generally entitled only to the tax attributes from its own premerger experience and not from the experience of the other corporations merged. More recently, however, this separate entity rule appears not to have been followed.

> *As a result, present practice rests on court-made law which is uncertain and frequently contradictory.* (Emphasis added.)

See also, S. Rep. No. 1622, 83d Cong., 2d Sess., p. 52 (3 U.S.C. Cong. & Adm. News (1954) 4621, 4683). The "separate entity rule" referred to above was established in *New Colonial Ice* v. *Helvering*, 292 U.S. 435 (1934), wherein the Supreme Court held that a corporation acquiring the assets of another corporation in what, today, would presumably be classified as a C reorganization was not entitled to carry forward and deduct the transferor corporation's net operating losses. Cases department from this "separate entity rule" include *Stanton Brewery* v. *Commissioner*, 176 F. 2d 573 (C.A. 2, 1949) holding, with Judge Learned Hand dissenting, that the surviving corporation in a statutory merger was entitled to carry forward and utilize the unused excess profits credit of the merged corporation.16/ With respect to net operating loss carrybacks, the Tenth Circuit, on the other hand, held, in *Standard Paving Co.* v. *Commissioner*, 190 F. 2d 330 (1951), that, following the tax-free liquidation of a subsidiary corporation into its parent, the parent was not entitled to carry back such a loss to a pre-liquidation taxable year of the subsidiary for the stated reason that the subsidiary no longer existed, even though the parent's loss was incurred as the result of completing certain long-term construction contracts which had been initiated

16/ This case involved not the regular corporate tax and the predecessor of Section 172, but the wartime excess profits tax, which was imposed by reference to the average taxable income of prior years. The majority invoked *Helvering* v. *Metropolitan Edison Co.*, 306 U.S. 522 (1939), involving not a loss carryover, but the amortization of discount after a merger.

by the subsidiary and had in fact produced the subsidiary's income.[17/]

It was against this "uncertain and frequently contradictory" background that Congress sought to impose order by the enactment of Section 381. This purpose would be wholly frustrated by acceptance of New Aetna's argument that the statute should be applied selectively, in accordance with New Aetna's perception of the "sole aim" (Br. 17) of Section 381. Indeed, the very conclusion which New Aetna urges upon this Court (Br. 21), that "An appropriate, sensible and consistent result can be reached in this and all cases by holding, in effect, that Section 381(b)(3) is inapplicable where inter-company apportionment problems are entirely absent," is the antithesis of the result sought by Congress and plainly expressed in the statute. "It is quite unlikely that the stated purposes of certainty, consistency and objectivity are to be achieved if each court considering a loss carryover problem adds a gloss of judicial exceptions." Maxwell Hardware Co. v. Commissioner, 343 F. 2d 713, 718-719 (C.A. 9, 1965). Indeed,

17/ Cases arising under the 1939 Code but decided after 1954 include Wisconsin Central Railroad Co. v. United States, 296 F. 2d 750 (Ct. Cl., 1961) (holding that a net operating loss could not be carried back to a year of a predecessor corporation following a reorganization under Section 77(m) of the Bankruptcy Act, c. 541, 30 Stat. 544 (11 U.S.C. §205)), and F. C. Donovan, Inc. v. United States, 261 F. 2d 470 (C.A. 1, 1958) (holding that a net operating loss of a parent corporation could be carried back to a taxable year of a subsidiary corporation ending prior to the liquidation of the subsidiary into the parent).

in light of the expressed Congressional purpose in enacting Section 381--to impose order where confusion existed--New Aetna's argument (Br. 10-21) that the "sole" purpose of Section 381(b)(3) is to avoid accounting problems (a purpose never mentioned in the committee reports) is simply wrong.

We do not deny that there is evidence in the legislative history of Section 381 and other sources indicating that Congress was mindful of the accounting problems that might be raised by the general allowance of net operating loss carrybacks following corporate reorganizations. See, e.g., Senate Hearings before the Committee on Finance on the Internal Revenue Code of 1954, 83d Cong., 2d Sess., pp. 404-405. Indeed, the Government made an argument somewhat analogous to New Aetna's herein, in the context of whether certain multi-corporate amalgamations constituted F reorganizations and therefore came with Section 381(b)'s exception, to urge that accounting considerations negated the presence of F reorganizations. See, e.g., Movielab, Inc. v. United States, 494 F. 2d 693 (Ct. Cl., 1974).[18] It does not follow, however, that accounting and allocation problems were of paramount importance. On the contrary, net operating loss carrybacks are allowed in certain limited circumstances, and net operating loss carryovers allowed generally, without requiring allocation. Thus, if

18/ In light of repeated judicial rejection of the Government's position that parent-subsidiary liquidations and multi-corporate consolidations could not constitute F reorganizations, the Government has abandoned its litigating effort in this area. Rev. Rul. 75-561, 1975-52, Int. Rev. Bull. 20.

corporation X merges into corporation Y, and Y thereafter incurs a net operating loss as a result of the combined operation of the businesses formerly conducted by X and Y separately, such loss may be carried back in full to a pre-merger taxable year of Y (although not of X) with no requirement that the loss be allocated between the businesses formerly conducted separately by X and Y. H. Rep. No. 1337, supra, p. A135; S. Rep. No. 1622, supra, p. 276 (3 U.S.C. Cong. & Adm. News (1954), p. 4273 and p. 4915). With respect to net operating loss carryovers, Section 381(c)(1) specifically allows such carryovers, following a transaction described in Section 381(a), without requiring allocation. See, Rev. Rul. 58-603, 1958-2 Cum. Bull. 147.

On the other hand, an examination of those transactions to which the restriction of Section 381(b)(3) is not applicable suggests that Congress did intend, at least with respect to net operating loss carrybacks, to codify the "separate entity rule" of New Colonial Ice, although modified to reflect economic reality. Thus, B and E reorganizations are outside the scope of Section 381 altogether, while F reorganizations are specifically excepted from Section 381(b). The reason for these exceptions is apparent. B reorganizations involve stock for stock exchanges at the shareholder level without affecting in the slightest the continuing legal identity of the corporation. Sec. 368(a)(1)(B). Likewise, E reorganizations involve the recapitalization of a single corporation. Sec. 368(a)(1)(E); Helvering v. Southwest Corp., 315 U.S. 194, 202 (1942). Thus, in both B and E

reorganizations the legal and economic identity of the corporate taxpayer remains unchanged, and there is no basis for denying the carryback. Similarly, F reorganizations involve a "mere change in identity, form, or place of organization." Sec. 368(a)(1)(F). This provision contemplates the simplest corporate changes (such as changing the state of incorporation or renewing a corporate charter) with no change in shareholder interests. Helvering v. Southwest Corp., supra, pp. 202-203. While the legal identity of the corporation is altered, its economic identity (both at the corporate level and the shareholder level) remains unchanged and there is again no reason to deny the carryback.[19] Thus, by excluding F reorganizations from the restriction of Section 381(b)(3), Congress assured that allowance of the net operating loss carryback would "be based upon economic realities rather than upon such artificialities as the legal form of the reorganization." H. Rep. No. 1337, supra, p. 41; S. Rep. No. 1622, supra, p. 52.

19/ This "entity" concept is also embodied in the example from the Committee Reports set forth above, p. 38. That is, where corporation X merges into corporation Y and Y thereafter incurs a net operating loss, such loss may be carried back to a pre-merger taxable year of Y but not of X. Thus, the entity, Y, which incurs the loss may carry such loss back to reduce its own prior income, but cannot use such loss to reduce the prior income of a separate entity, X.

However, where both the legal and the economic identity of the corporation are destroyed, there is a sound economic reason for denying the net operating loss carryback. Assume that in 1960 corporation X derives income and pays the resulting tax. This tax is born directly by X and indirectly by X's shareholders. See, <u>Newmarket Manufacturing Co</u>. v. <u>United States</u>, 233 F. 2d 493, 497 (C.A. 1, 1956). In 1962, X merges into corporation Y, a shell corporation with the stockholders of X receiving stock of Y's parent corporation, upon terms which substantially shift the shareholders' proprietary interests. Thereafter Y continues unchanged the business formerly conducted by X and, in 1963, incurs a net operating loss. If Y were allowed to carry back this loss to X's taxable year 1960, to reduce X's income for that year and thereby generate a tax refund, this refund would not go to the legal entity (X) or the economic interests (X's shareholders) which actually incurred and bore the tax. This refund, rather, would go to a wholly new set of legal and economic interests (Y and Y's shareholders). In such circumstances, Congress rationally concluded that the income averaging purpose of the net operating loss carryback provided in Section 172(b) should properly be denied.[20/]

It is in this precise situation that this case is situated. While New Aetna repeatedly emphasizes (Br. 12, 19) that it

20/ In somewhat different fashion, Section 382 of the Code (26 U.S.C.) provides additional rules governing net operating loss carryforwards in certain circumstances.

conducted substantially unchanged the business formerly conducted by Old Aetna, it wholly ignores the substantial shift in shareholder interests occurring upon the merger of Old Aetna into New Aetna (R. 33-35). But this shift in proprietary interest cannot be ignored.[21] However similar New Aetna might be to Old Aetna as an economic entity at the corporate level, the fact remains that New Aetna is not the same legal entity as was Old Aetna and New Aetna does not have the same shareholder interests as Old Aenta had.[22] In light of this, the set of legal and economic interests which incurred and bore Old Aetna's 1963 income tax liability (Old Aetna and its shareholders) is not the same set of interests that would receive the $4,500,000 tax refund which New Aetna here seeks. In enacting the F reorganization exception to Section 381(b)(3), Congress determined that, when a separate legal entity incurs the net operating loss, the carryback is allowed only when the shareholder interests are substantially

21/ Every case holding that multicorporate amalgamations could be F reorganizations, and thereby excepted from the Section 381(b)(3) restriction, emphasized that no change in proprietary interest occurred. See, e.g. Movielab, Inc. v. United States, supra; Home Construction Corp. v. United States, 439 F. 2d 1165 (C.A. 5, 1971); Estate of Stauffer v. Commissioner, 403 F. 2d 611 (C.A. 9, 1968).

22/ Prior to the reorganization, Aetna Life owned 4,312,535 shares, or 61.61 percent of Old Aetna's 7,000,000 shares, and 3,952 other shareholders owned 2,687,464 shares, or 38.39 percent. Immediately prior to the reorganization, Aetna Life had 20,000,000 shares outstanding. Stockholders of Old Aetna other than Aetna Life received 5,106,181 shares of Aetna Life in exchange for their shares of Old Aetna. They thus owned 5,106,181 of the 25,106,181 shares, or 20.34 percent of Aetna Life, and had a 20.34 percent interest in the stapled trust after the shares of New Aetna were distributed to that trust. (R. 14-15, 108-109.)

identical. Helvering v. Southwest Corp., supra, pp. 202-203. New Aetna fails to meet that standard in this case

Moreover, neither the language nor the history of Section 381 supports New Aetna's argument that the statute might not apply in some circumstances. We have previously reviewed the language of the statute itself. New Aetna admits (Br. 19) that the statute applies literally to this case. More importantly, for present purposes, there is nothing in Section 381(b)(3) that indicates that it should be applied on a selective basis. On the contrary, the statute clearly states that, following the types of acquisition transactions enumerated in Section 381(a), the acquiring corporation "shall not be entitled to carry back a net operating loss" for a post-acquisition year to a taxable year of the transferor corporation. The statute admits of only the F reorganization exception, and New Aetna no longer contends that it falls within that exception.

Turning again to the legislative history of Section 381, far from indicating a desire on the part of Congress that the statute be applied in accordance with some vaguely determined purpose, the Congressional committee reports affirmatively disclose that the statute, where literally applicable, is to apply regardless of the facts of the particular case. Thus, in a transaction to which the statute is made applicable, "the corporation making a distribution or transfer of property described in subsection (a) must end its taxable year on the date of distribution or transfer" (emphasis added) under Section 381(b)(1). H. Rep.

No. 1337, _supra_, p. A135. With respect to the items specified in Section 381(c) to be carried over from the distributor or transferor corporation to the acquiring corporation, the Ways and Means Committee report states that "Subsection (c) of this section contains 16 paragraphs, each of which specifies an item or tax attribute of the distributor or transferor corporation _which is to be taken into account_ by the acquiring corporation as of the close of the date of distribution or transfer _in the manner and to the extent provided_ with respect to such item." (Emphasis added.) H. Rep. No. 1337, _supra_, p. A135. Similarly, with respect to the restriction on net operating loss carrybacks, the report states that "Paragraph (3) of subsection (b) provides that an acquiring corporation to which property is distributed or transferred in a corporate transaction described in paragraphs (1) and (2) of subsection (a) _is not entitled to carry back a net operating loss_ for a taxable year ending after the date of distribution or transfer to a taxable year of the distributor or transferor corporation." (Emphasis added.) H. Rep. No. 1337, _supra_, p. A135. This is to be contrasted with the Ways and Means Committee statement that "The section is not intended to affect the carryover treatment of an item or tax attribute not specified in the section or the carryover treatment of items or tax attributes in corporate transactions not described in subsection (a)." H. Rep. No. 1337, _supra_, p. A135. Substantially identical language is contained in the report of the Senate Committee on Finance. S. Rep. No. 1622, _supra_, pp. 276-277 (3 U.S.C. Cong. & Adm. News (1954), pp. 4914-4915).

It is evident from the above committee reports that Congress did not intend that the straightforward, albeit complex, provisions of Section 381 were to be clouded by ad hoc determinations of the statute's applicability.

An argument substantially analogous to New Aetna's herein was made in Braunstein v. Commissioner, 374 U.S. 65 (1963), aff'g 305 F. 2d 949 (C.A. 2, 1962). That case involved the application of Section 117(m) of the Internal Revenue Code of 1939 (Section 341 of the 1954 Code), dealing with collapsible corporations. Application of the statute in that case rendered the gain on certain sales of stock ordinary income rather than capital gain. Taxpayers argued that the purpose of the statute, as evidenced in the congressional committee reports, was to prevent the conversion of ordinary income upon the sale of an asset into capital gains by use of a corporation. They further argued that, since they would have realized capital gain in that case if they had not used a corporation, the statute was having the unintended effect of converting capital gain into ordinary income. Agreeing in the main with taxpayers' analysis of the legislative history, both this Court and the Supreme Court nevertheless rejected their argument, holding that the statute could not be applied on an ad hoc basis. 305 F. 2d, p. 957; 374 U.S., p. 71. As the Supreme Court emphasized, it was the absence of any indication whatsoever, either in the language of the statute itself or in its legislative history, that the statute was to be applied selectively that was fatal to the taxpayers' position (374 U.S., pp. 72-73):

> We find no basis in either the terms or the history of §117(m) for concluding that Congress intended the Commissioner and the courts to enter this thicket and to arrive at *ad hoc* determinations for every taxpayer.

Similarly here, a critical element missing from New Aetna's argument is any congressional indication whatsoever that the statute might not apply in some circumstances.

Finally, a brief review of the evolution of the Section 381(b)(3) restriction in the 83d Congress further establishes that it was not intended to be selectively applied. Section 381 (b)(3) of H. R. 8300 (which was to become the 1954 Code) as passed by the House of Representatives and sent to the Senate contained a flat prohibition upon net operating loss carrybacks following the types of corporate acquisitions enumerated in Section 381(a). See, H. Rep. No. 1337, *supra*, p. A135. It was perceived by the organized tax bar, however, that this provision was unduly restrictive. In hearings before the Senate Committee on Finance, the Section of Taxation of the American Bar Association and the Section on Taxation of the New York State Bar Association each urged that the restriction on net operating loss carrybacks be liberalized to allow such carrybacks in circumstances such as the reincorporation of the same corporation in a different state, the renewal of an expired corporate charter, and the liquidation of a wholly-owned subsidiary into its parent. Senate Hearings, *supra*, pp. 343, 405, and 3 Senate Hearings before the Committee on Finance on the Internal Revenue Code of 1954, 83d Cong., 2d Sess., pp. 1531, 1543. The Senate responded by adding

the exception for F reorganizations. S. Rep. No. 1622, <u>supra</u>, p. 276. The House receded without specific comment but apparently regarded the Senate amendment as a "technical change" which left intact the otherwise complete prohibition of net operating loss carrybacks in the enumerated transactions. H. Conf. Rep. No. 2543, 83d Cong., 2d Sess., p. 39 (3 U.S.C. Cong. & Adm. News (1954), 5280, 5298). Thus, Congress was fully aware of the action it was taking in enacting Section 381(b)(3)'s restriction on net operating loss carrybacks and provided specific relief only for F reorganizations (for which, we again note, New Aetna cannot qualify). Simply stated, an informed Congress enacted Section 381(b)(3) with full realization of the existence and operation of the net operating loss provisions, but chose to make no distinction other than for the F reorganization. Cf. <u>Hanover Bank</u> v. <u>Commissioner</u>, 369 U.S. 672, 688 (1962). "The task of revision should be left to Congress." <u>Braunstein</u> v. <u>Commissioner</u>, <u>supra</u>, 305 F. 2d, p. 959.

C. <u>Old Aetna's merger into New Aetna did not constitute a B reorganization</u>

As we discussed above, the District Court correctly held, on the basis of the plain language of Sections 368(a)(1)(C), 381(a), and 381(b)(3), that the merger of Old Aetna into New Aetna constituted the acquisition by New Aetna of the assets of Old Aetna in exchange for stock of Aetna Life and, thus, constituted a C reorganization. This coincides with the ruling that Old Aetna and Aetna Life sought and obtained from the Internal Revenue Service. On that basis, New Aetna is clearly not entitled

to carry back its net operating losses for post-acquisition years to a taxable year of Old Aetna. (R. 123, 142.) New Aetna now argues (Br. 22-35), however, that, at least when viewed from Aetna Life's perspective, this transaction merely consisted of the acquisition by Aetna Life, solely in exchange for its voting stock, of the minority shareholders' stock in Old Aetna and, thus, constituted a B reorganization, which would place this transaction outside the scope of Section 381. This argument, we submit, is unmeritorious for a host of interrelated reasons and should be rejected.[23/]

Initially, Aetna Life's perspective of this transaction is, in this context, irrelevant. This case does not involve the tax liability of Aetna Life. It involves, rather, the tax liability of Old Aetna and New Aetna. The issue turns on the circumstances of Old Aetna's merger into New Aetna. New Aetna concedes (Br. 23)

23/ New Aetna argues (Br. 35-37) that the lower court erred in its holding that this transaction constituted a C and not a B reorganization by basing its conclusion, in part, upon the fact that Old Aetna and Aetna Life sought and received a ruling from the Internal Revenue Service that their proposed transaction would constitute a C reorganization. (R. 30, 44.) This argument is based upon a misreading of Judge Blumenfeld's opinion. The comments relating to such ruling are contained in part II of the opinion (R. 117-120) wherein the lower court addressed and rejected New Aetna's argument that the transaction did not constitute a reorganization at all. Judge Blumenfeld was of the opinion (correctly, we submit) that, since Aetna Life's ability to meet the requirements of Section 815(f)(3)(B) depended upon this transaction's being a "reorganization," that fact militated against holding that it was not a reorganization for purposes of Section 381. It was in this context that reference was made (R. 117) to the ruling request. On the other hand, part III of the opinion (R. 120-127), wherein Judge Blumenfeld addressed and rejected New Aetna's argument that this transaction constituted a B reorganization contains no reference whatsoever to the ruling request. Thus, since New Aetna's argument in this Court is based upon an asserted error which the District Court did not commit, we will not further address that argument.

that the merger itself, as if affected Old Aetna and New Aetna, constituted a C reorganization, that is, a stock for assets exchange. This triggers the application of Section 381.[24] Aetna Life is a stranger to this determination, and its perspective of the transaction is quite beside the point.

More importantly, the transaction here did not constitute a stock-for-stock B reorganization. The statute defines a B reorganization as the acquisition by one corporation, solely in exchange for its own or its parent corporation's voting stock, of the voting stock of another corporation.[25] This provision contemplates an exchange of stock directly between the acquiring corporation and the shareholders of the "target" corporation. This might be accomplished through negotiations between the acquiring corporation and the individual shareholders of the target corporation, or through a single or successive tender

---

24/ Thus, New Aetna is not only denied the net operating loss carrybacks which it here seeks under Section 381(b)(3), but is also required to take into account the numerous items under Section 381(c).

25/ Section 368(a)(1)(B) provides that the term "reorganization" means--

> (B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation) of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition);

offers. In either case, the election remains with the shareholders to accept or reject the exchange offer.[26] Moreover, in a B reorganization the target corporation is completely bypassed, and its identity is totally untouched by any changes occurring at its shareholder level.

Clearly, no such transaction occurred in this case. At no time did Aetna Life exchange, or even offer to exchange, its stock for the minority shareholders' stock of Old Aetna. In fact, the outstanding shares of Old Aetna (in contrast to the 13,300,000 shares of Aetna Life) were never exchanged at all; upon the merger of Old Aetna into New Aetna, the Old Aetna shares were merely cancelled. (R. 18.) Also, upon the merger of Old Aetna into New Aetna, Old Aetna ceased to exist. (R. 19.) The requirements of a B reorganization are simply not present in this case, and the collateral consequences of a B reorganization therefore are not pertinent. Turnbow v. Commissioner, 368 U.S. 337 (1961).

There were, of course, several stock transfers which occurred in this transaction. None of these, however, constituted B reorganizations for purposes of deciding the issue presented in this case. First, there is Aetna Life's formation of Farmington

26/ A prudent corporation, desirous of obtaining a specified level of control, will protect itself against the eventuality that an insufficient number of the target corporation's shareholders will respond favorably to its offer by including as a condition subsequent to its offer that a sufficient number of such shareholders agree to the exchange.

Valley (New Aetna) and its exchange of 13,300,000 shares of Aetna Life stock for all of the stock of Farmington Valley. Although technically a B reorganization, this exchange is more properly treated as tax-free exchange under Section 351 of the Code[27/] (see Rev. Rul. 70-433, 1970-2 Cum. Bull. 82) and is, in any event, not the critical transaction in this case. The critical transaction is the merger of Old Aetna into New Aetna. Analytically, the merger consisted of two stock transfers: (1) the transfer of the Aetna Life stock from New Aetna to Old Aetna in exchange for all of the assets of Old Aetna (a C reorganization), and (2) the transfer of the Aetna Life stock from Old Aetna to its shareholders and the cancellation of the Old Aetna stock. Raybestos-Manhattan, Inc. v. United States, 296 U.S. 60 (1935). None of these transfers, alone or in combination, directly or indirectly, constituted an exchange of stock between Aetna Life and the shareholders of Old Aetna. On the contrary, the Aetna Life stock held by New Aetna was specifically exchanged for the assets of Old Aetna, and, upon the merger of Old Aetna into New Aetna, the corporate existence of Old Aetna was destroyed. Thus, this transaction cannot constitute a B reorganization. This Court, moreover, has previously

27/ This is the manner in which Old Aetna and Aetna Life characterized the transaction in their request for a ruling. (R. 30.)

disapproved the notion that the technical requirements of the reorganization provisions could be disregarded in order to reach particular results. Commissioner v. Berghash, 361 F. 2d 257 (1966), aff'g, 43 T.C. 743 (1965). See also, Gallagher v. Commissioner, 39 T.C. 144, 161-162 (1962).

Furthermore, the choice of Aetna Life and Old Aetna to use the method of reorganization which they did employ--a stock for assets exchange--was the product of several significant business purposes, which precluded the choice of a stock-for-stock reoganization. That is, the choice of the C reorganization route was the result of the confluence of at least four objectives: (1) the desire on the part of the management of Aetna Life and Old Aetna to achieve an identity of shareholder interest with respect to both Aetna Life and Old Aetna, (2) Aetna Life's desire to remove the Old Aetna stock from its asset base to lower its life insurance company income taxes under the Phase I computation, (3) the objective that these first two purposes be accomplished tax free, and (4) the objective that the entire series of steps comprising this transaction be completed by December 31, 1964.

All of these objectives could be, and in fact were, achieved by the use of a C reorganization. Thus, the series of steps by which Aetna Life formed Farmington Valley (New Aetna) as a wholly-owned subsidiary and Old Aetna merged into New Aetna with the consequent cancellation of the Old Aetna stock resulted in the sought-after identity of shareholder interest. By means of the merger, the Aetnas could ensure that there would be

no outstanding minority interest in Old Aetna following the merger, and also allowed the Aetnas to control the terms of the exchange whereby each share of Old Aetna received 1.9 shares of Aetna Life. The subsequent distribution by Aetna Life of the New Aetna stock to the stapled trust removed that stock from Aetna Life's asset base. Further, the application of various provisions of the Code rendered the entire series of steps tax free to all parties: (a) Aetna Life's formation of Farmington Valley was tax free under Section 351, (b) the merger of Old Aetna into Farmington Valley (New Aetna) was tax free to Old Aetna under Sections 361(a) and 368(a)(1)(C), (c) the receipt of the Aetna Life stock by the Old Aetna shareholders was tax free to them under Sections 354(a) and 368(a)(1)(C), (d) the distribution of the New Aetna stock by Aetna Life was tax free to it under Section 815(f)(3), and (e) the distribution of the New Aetna stock by Aetna Life was tax free to Aetna Life's shareholders under Section 355. Finally, by use of the merger of Old Aetna into New Aetna, the Aetnas were able to control the sequence of events and ensure that all of the contemplated transactions would be completed by the end of the taxable year 1964. This ensured not only that the stated exchange ratio (1.9 to 1) of Aetna Life stock to Old Aetna stock could be maintained, but also ensured that Aetna Life could eliminate the Old Aetna stock from its asset base in time to reflect the tax savings under its Phase I computation for the taxable year

1964.[28/] Thus, all of the Aetnas' objectives were achieved by the form that this series of transactions actually took, and the use of a C reorganization was an element critical thereto.

In contrast, a stock-for-stock B reorganization was a disadvantageous alternative for several reasons.[29/] That is, an attempt by Aetna Life to acquire the outstanding minority shares of Old Aetna by means of a tender offer could have several undesirable consequences. These stem from the likelihood, which New Aetna concedes (Br. 27), that not all of the minority shareholders of Old Aetna would respond to such a tender offer. Thus, if several of the Old Aetna shareholders failed to respond to a tender offer by Aetna Life, the objective of an identity of shareholder interests with respect to Aetna Life and Old Aetna could not be achieved. To overcome this, Aetna Life might have been required to offer non-responding Old Aetna shareholders a somewhat more favorable exchange ratio, which in turn would have complicated Aetna Life's changes in its capital structure, which were geared to the stated exchange ratio of 1.9 to 1. Further modifications in the exchange ratio and/or Aetna Life's capital structure, moreover, might or might not have been approved by Aetna Life's shareholders or the Connecticut Insurance Commissioner. Nor could there be any assurance

28/ See supra, p. 6, fn. 3. In this connection, note that, in determining Aetna Life's partial tax under the Phase I computation, Section 805(b)(2)(B) provides that the current earnings rate is determined by dividing the investment yield by "the mean of the taxpayer's assets at the beginning and end of the taxable year."

29/ It should be noted also that if a B reorganization, whereby Aetna Life was to acquire stock of Old Aetna giving it 80 percent control in exchange for its own voting stock, had been contemplated or intended, there would have been no need or purpose for the organization of Farmington Valley (New Aetna).

that a sufficient number of Old Aetna shareholders would respond to a tender offer by the end of 1964 to enable Aetna Life to make the Section 815(f) distribution in that year.

On the other hand, even if it is assumed that enough Old Aetna shareholders would have responded to a tender offer in 1964 to have given Aetna Life the requisite 80-percent control for a distribution of the Old Aetna stock in that year, the Aetnas could never thereafter achieve the desired identity of shareholder interests in a tax-free transaction. That is, following a distribution by Aetna Life of more than 80 percent but less than 100 percent of the Old Aetna stock, all of the provisions of the Code that confer tax free status on various stock transfers that are contingent on 80-percent control could never be complied with. Thus, any subsequent acquisition by Aetna Life of further minority shares of Old Aetna and their distribution to the stapled trust would be taxable to the Old Aetna shareholders involved, the Aetna Life shareholders, and to Aetna Life itself (as a Phase III distribution). In short, the Aetnas eschewed a stock-for-stock B reorganization for several valid reasons, both business and tax related, and New Aetna's suggestion that the transaction they actually engaged in should be treated as a B reorganization does not comport with the facts of this case.

This conclusion is further confirmed by the history and structure of the life insurance company income tax provisions that precipitated the reorganization of Old Aetna. As indicated previously

in the statement of facts, Congress first enacted an ameliorative provision to the Phase III distribution tax rules in 1962 with the enactment of the Act of October 23, 1962, P.L. 87-585, 76 Stat. 1134. This provided that the distribution of the stock of a controlled insurance subsidiary would not subject the parent life insurance company to a distribution tax if control had been acquired by means of a B reorganization. Aetna Life, however, did not seek to acquire control of Old Aetna pursuant to this provision. It chose instead to lobby for a further relaxation of the distribution rules--specifically, to allow control to be acquired through a C reorganization. Congress responded by the addition of Section 815(f) to the Code by the Act of September 2, 1964, P.L. 88-571, 78 Stat. 857, which did allow for the C reorganization.30/ Immediately thereafter, on September 3, 1964, the boards of directors of Aetna Life and Old Aetna met and approved plans for the reorganization of Old Aetna which exactly conformed to the new Section 815(f)(3)(B)(ii)'s description of a qualifying transaction employing a C reorganization.

Indeed, Section 815(f)(3)(B) itself exemplifies the critical distinction between stock-for-stock B reorganizations and stock-for-assets C reorganizations. Thus, Section 815(f)(3)(B)(i) provides that an otherwise qualifying distribution will be tax free under the Phase III computation if control is acquired "in a transaction qualifying as a reorganization under section 368(a)(1)(B)." Recognizing the more complex requirements

30/ In their request for a ruling, Aetna Life and Old Aenta stated that "The contemplated reorganization of Aetna Life and Aetna Casualty has been made possible by the enactment last week of H. R. 5739." (R. 32.)

of fitting C reorganizations into the new distribution tax exception, Section 815(f)(3)(B)(ii) provides that control can be acquired--

> Solely in exchange for stock of the distributing corporation which stock is immediately exchanged by the controlled corporation in a transaction qualifying as a reorganization under section 368(a)(1)(A) or (C), if the controlled corporation has at all times since its organization been wholly owned by the distributing corporation and the distributing corporation has at all times since December 31, 1957, owned stock representing * * * [at least 50 percent control] of the corporation the assets of which have been transferred to the controlled corporation in the section 368(a)(1)(A) or (C) reorganization.

In order to qualify under this latter provision, it is necessary that the life insurance company parent corporation create a wholly owned shell subsidiary corporation, the assets of which are solely shares of the parent corporation's stock, which shares are immediately exchanged for the assets of the insurance company subsidiary. This is exactly the series of steps which the Aetnas engaged in to reorganize Old Aetna. Thus, both Congress and the Aetnas understood that the distinction between B and C reorganization was that in the former the corporate identity of the insurance subsidiary is left intact while in the latter it is not. The Aetnas chose the latter route. This choice was based on numerous considerations, as outlined above, and the Aetnas and their shareholders derived several significant tax advantages from that choice. New Aetna should not now be heard to complain that its choice results in a single disadvantage.

New Aetna's reliance (Br. 25-30) on Casco Products Corp. v. Commissioner, 49 T.C. 32 (1967) is misplaced. In Casco Products, Standard Kollsman Industries, Inc. (SKI), sought to acquire 100 percent ownership of the stock of Old Casco. By successive tender offers, SKI was able to purchase 91 percent of the Old Casco stock. To acquire the remaining nine percent, SKI formed a wholly-owned shell subsidiary corporation, SKO, Inc., and Old Casco was merged into SKO (New Casco) upon terms whereby all of the shares of Old Casco were cancelled, the outstanding minority shareholders of Old Casco received cash, and SKI resulted in owning 100 percent of New Casco. In holding that New Casco was entitled to carry back a net operating loss to a taxable year of Old Casco, the Tax Court decided (five judges dissenting) that the merger of Old Casco into New Casco was merely a "legal technique" for redeeming the minority shareholders' interest in Old Casco, and the fact that the merger might also constitute a reorganization should be disregarded. The fundamental error of Casco Products is its disregard of the reorganization provisions. See, Commissioner v. Berghash, supra. The incidence of federal taxation does not depend upon the presence or absence of a "legal technique." The tax is imposed upon what is actually done, and not what the tax might have been had a particular transaction been cast in a different form. Commissioner v. Nat. Alfalfa Dehydrating, 417 U.S. 134 (1974). While substance controls over form (Gregory v. Helvering, 493 U.S. 465 (1935)), where the form of a transaction matches its substance, "the method pursued is determinative

for tax purposes without regard to the fact that different tax results would have attached if the alternative procedure had been followed." Woodruff v. Commissioner, 131 F. 2d 429, 430 (C.A. 5, 1942). Thus, which "legal technique" is employed in the particular case is highly relevant in determining the tax consequences of a transaction, particularly in light of the statutory prohibition, in Section 381(b)(3), against certain net operating loss carrybacks following the types of asset acquisition transactions enumerated in the statute.

The type of reorganization involved in Casco Products was a statutory merger--an A reorganization. As the dissenters in that case pointed out (49 T.C., pp. 37-38), since New Casco was attempting to carry back its net operating loss to a taxable year of Old Casco, the crucial question was whether the nine percent shift in ownership occurring on the merger left the transaction outside Section 381(b)'s exception for F reorganizations. Ignoring the fact that a reorganization did in fact take place is not a creditable response to that issue. We submit that the majority's rationale in Casco Products is fundamentally unsound and provides no support for New Aetna's position herein, especially since New Aetna has abandoned its arguments that the merger of Old Aetna into New Aetna did not constitute a reorganization[31/] or constituted an F reorganization.

31/ In the lower court, New Aetna urged Casco Products in support of its argument that the merger of Old Aetna into New Aetna did not constitute a reorganization. (R. 117.) The District Court rejected this argument on the grounds, outlined above, that the form of a transaction is often determinative of its tax consequences. (R. 119.) In addition, the transaction had to be treated as a reorganization in order for Aetna Life to comply with the terms of Section 815(f)(3)(B). (R. 119-120.)

Moreover, even application of that rationale to this case does not aid New Aetna's argument that the merger involved here constituted a stock-for-stock B reorganization. New Aetna argues (Br. 28) that, as the minority shareholders in Old Casco received cash for their stock, the issue in Casco Products was whether that transaction was a reorganization or merely a redemption. New Aetna then makes the facile assumption (Br. 29) that if the minority shareholders in Old Casco had received stock instead of cash, the Tax Court would have found the transaction to be a B reorganization. Nothing in Casco Products supports this conclusion. Here, as in that case, there appears to have been no legal method by which Old Aetna or Aetna Life could have forced the minority shareholders of Old Aetna to accept a simple redemption of their stock, whether it be for cash or shares of Aetna Life. Consequently, as in Casco Products, the merger of Old Aetna into New Aetna, whereby the minority shareholders of Old Aetna received Aetna Life stock, was essential to the Aetnas' plan of reorganization. Thus, this transaction constituted a stock-for-assets C reorganization. Similarly, in Casco Products, if the minority shareholders of Old Casco had received stock instead of cash, the merger there would, nonetheless, have constituted an A reorganization (if they had received stock in New Casco) or a C reorganization (if they had received stock in New Casco's parent, SKI). In either event, Section 381(b)(3)'s prohibition on net operating loss carrybacks would still apply. There is simply nothing in

Casco Products to suggest that the use of stock in that case would have rendered the transaction a B reorganization. Both in this case and in Casco Products, the merger of the old corporation into the new corporation precludes the transaction's being a B reorganization.

New Aetna also relies (Br. 30-33) on several revenue rulings; these, however, do not establish the purported overlap between B and C reorganizations which New Aetna urges here.[32/] Indeed, as follows from our discussion above, the same transaction cannot be both a stock-for-stock B reorganization and a stock-for-assets C reorganization. New Aetna's position fails to account for the critical element of distinction that in B reorganizations the identity of the target corporation remains intact while in C reorganizations it does not. This distinction is recognized in these revenue rulings. Thus, in Rev. Rul. 67-448, 1967-2 Cum. Bull. 144, the following transaction was held to constitute a B reorganization:

(a) P and Y are separate corporations, each publicly owned; P desired to acquire 100 percent of the stock of Y;

(b) P formed a wholly owned subsidiary, S, whose only asset was a block of P's voting stock;

32/ New Aetna also cites (Br. 23-24) Bittker and Eustice, supra, p. 14-8, and several cases to suggest that various definitions of reorganizations under Section 368(a)(1) often overlap. None of these authorities remotely suggest, however, that the same transaction can be both a stock-for-stock B reorganization and a stock-for-assets C reorganization.

(c) S merged into Y upon terms whereby the S stock held by P became Y stock and Y's shareholders exchanged their Y stock for the P stock held by S;

(d) P, as a result, ended in owning all of the stock of Y. This was held to be a B reorganization because the corporate identity of Y remained unchanged and P acquired the outstanding Y stock solely in exchange for its own voting stock, albeit through a series of intermediate steps. This was not an A or C reorganization because "no assets of Y were transferred to nor acquired by another corporation in the transaction." 1967-2 Cum. Bull., p. 145. To the same effect are Rev. Rul. 74-564, 1974-2 Cum. Bull. 124, and Rev. Rul. 74-565, 1974-2 Cum. Bull. 125. By contrast, in Rev. Rul. 67-274, 1967-2 Cum. Bull. 141, a transaction whereby Y corporation acquired all of the outstanding stock of X corporation solely in exchange for Y voting stock and X was thereafter liquidated into Y was held to be a C reorganization. "The substance of the transaction is an acquisition of assets to which section 368(a)(1)(B) of the Code does not apply." 1967-2 Cum. Bull., p. 142. See also, Bittker and Eustice, _supra_, p. 14-39. Far from establishing that the merger of Old Aetna into New Aetna in this case constituted a B reorganization, these revenue rulings confirm the conclusion that it was a C and _not_ a B reorganization. Aetna Life did not end by owning all of the stock of Old Aetna, but rather by owning the stock of New Aetna.

In Rev. Rul. 57-278, 1957-1 Cum. Bull. 124, it was held that a stock-for-assets acquisition constituted a C reorganization although the acquiring corporation already owned a substantial

amount of the stock of the corporation the assets of which were acquired on the exchange. As New Aetna correctly observes (Br. 30-31), the issue there was whether the acquiring corporation's existing ownership of the target corporation's stock precluded the transaction's being a C reorganization, and reference was made to the fact that the 1954 Code for the first time had sanctioned the so-called "creeping" acquisition under B reorganizations. The reference to the B reorganization provisions merely recognized that all of the reorganization provisions have the same basic goal--the allowance of business adjustments without the imposition of tax--and ought to be interpreted in harmony with one another. This does not mean, however, that B and C reorganizations are the same, for they have demonstrably different requirements in many circumstances. See, e.g., Sec. 368(a)(2)(B), Appendix, *infra*. Compare, *Turnbow v. Commissioner*, *supra*. To repeat, the distinction critical to this case is that in a B reorganization the identity of the target corporation remains intact and the changes which occur take place only at the shareholder level. This is not so in a C reorganization, where the acquiring corporation acquires substantially all of the assets of the target corporation. The transaction involved in this case falls into this latter category.

In conclusion, we would re-emphasize a point made earlier in this brief in connection with New Aetna's first argument. That is, by the enactment of Section 381(b)(3), Congress

determined that, in asset acquisition reorganizations, a net operating loss of the acquiring corporation could be carried back to a taxable year of the transferor corporation only if the reorganization does not result in significant shifts in shareholder interests. Helvering v. Southwest Corp., supra. That is, only if the set of economic interests that bore the tax in the earlier year is the same set of interests that subsequently bears the net operating loss is the carry-back allowed. New Aetna fails to meet that standard in this case.

CONCLUSION

The judgment of the District Court is correct and should be affirmed.

Respectfully submitted,

SCOTT P. CRAMPTON,
Assistant Attorney General,

GILBERT E. ANDREWS,
ERNEST J. BROWN,
GEORGE G. WOLF,
Attorneys,
Tax Division,
Department of Justice,
Washington, D.C. 20530.

Of Counsel:

PETER C. DORSEY,
United States Attorney.

APRIL, 1976.

CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made upon opposing counsel by mailing four copies thereof, on this 14th day of April, 1976, in an envelope, with postage prepaid, properly addressed to him as follows:

William G. DeLana, Esquire
Day, Berry and Howard
1 Constitution Plaza
Hartford, Connecticut 06103

Gilbert E. Andrews
GILBERT E. ANDREWS,
Attorney.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 354. EXCHANGES OF STOCK AND SECURITIES IN CERTAIN REORGANIZATIONS.

(a) General Rule.--

(1) In general.--No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

* * *

SEC. 361. NONRECOGNITION OF GAIN OR LOSS TO CORPORATIONS.

(a) General Rule.--No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

* * *

SEC. 368. DEFINITIONS RELATING TO CORPORATE REORGANIZATIONS.

(a) [as amended by Sec. 218(a), Revenue Act of 1964, P.L. 88-272, 78 Stat. 19]. Reorganization.--

(1) In general.--* * *

(A) a statutory merger or consolidation;

(B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation) of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition);

(C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of substantially all of the properties of another corporation, but in determining whether the exchange is solely for stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded;

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356;

(E) a recapitalization; or

(F) a mere change in identity, form, or place of organization, however effected.

* * *

(c) Control.--For purposes of part I (other than section 304), part II, and this part, the term "control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

SEC. 381. CARRYOVERS IN CERTAIN CORPORATE ACQUISITIONS.

(a) General Rule.--In the case of the acquisition of assets of a corporation by another corporation--

* * *

(2) in a transfer to which section 361 (relating to nonrecognition of gain or loss to corporations) applies, but only if the transfer is in connection with a reorganization described in subparagraph (A), (C), (D) (but only if the requirements or subparagraphs (A) and (B) of section 354(b)(1) are met), or (F) of section 368(a)(1),

the acquiring corporation shall succeed to and take into account, as of the close of the day of distribution or transfer, the items described in subsection (c) of the distributor or transferor corporation, subject to the conditions and limitations specified in subsections (b) and (c).

(b) Operating Rules.--Except in the case of an acquisition in connection with a reorganization described in subparagraph (F) of section 368(a)(1)--

(1) The taxable year of the distributor or transferor corporation shall end on the date of distribution or transfer.

* * *

(3) The corporation acquiring property in a distribution or transfer described in subsection (a) shall not be entitled to carry back a net operating loss for a taxable year ending after the date of distribution or transfer to a taxable year of the distributor or transferor corporation.

(c) Items of the Distributor or Transferor Corporation.--The items referred to in subsection (a) are:

(1) Net operating loss carryovers.-- The net operating loss carryovers determined under section 172, subject to the following conditions and limitations:

* * *

SEC. 815. DISTRIBUTIONS TO SHAREHOLDERS.

* * *

(f) [as added by Sec. 4(a)(2), Act of September 2, 1964, P.L. 88-271, 78 Stat. 857]. Distribution Defined.-- For purposes of this section, the term "distribution" includes any distribution in redemption of stock or in partial or complete liquidation of the corporation, but does not include--

* * *

(3) any distribution after December 31, 1963, of the stock of a controlled corporation to which secton 355 applies, if such controlled corporation is an insurance company subject to the tax imposed by section 831 and if--

(A) control was acquired prior to January 1, 1958, or

(B) control was been acquired after December 31, 1957--

(i) in a transaction qualifying as a reorganization under section 368(a)(1)(B), if the distributing corporation has at all times since December 31, 1957, owned stock representing not less than 50 percent of the total combined voting power of all class of stock entitled to vote, and not less than 50 percent of the value of all classes of stock, of the controlled corporation, or

(ii) solely in exchange for stock of the distributing corporation which stock is immediately exchanged by the controlled corporation in a transaction qualifying as a reorganization under section 368(a)(1)(A) or (C), if the controlled corporation has at all times since its organization been wholly owned by the distributing corporation and the distributing corporation has at all times since December 31, 1957, owned stock representing not less than 50 percent of the total combined voting power of all classes of stock entitled to vote, and not less than 50 percent of the value of all classes of stock, of the corporation the assets of which have been transferred to the controlled corporation in the section 368(a)(1)(A) or (C) reorganization;

* * *

UNITED STATES DEPARTMENT OF JUSTICE

WASHINGTON, D.C. 20530

April 14, 1976

Address Reply to the
Division Indicated
and Refer to Initials and Number

SPC:GEA:GGWolf:mae
5-14-3248

4-16

A. Daniel Fusaro, Esquire
Clerk, U.S. Court of Appeals
for the Second Circuit
Room 1702, U.S. Courthouse
Foley Square
New York, New York 10007

Re: The Aetna Casualty and Surety Co. v. United States (C.A. 2 - No. 75-6131)

Dear Mr. Fusaro:

We are transmitting herewith for filing with your Court ten copies of the brief on behalf of the Appellee in the above-entitled case.

We are forwarding four additional copies to counsel for the Appellant, together with a copy of this letter.

Sincerely yours,

SCOTT P. CRAMPTON
Assistant Attorney General
Tax Division

Enclosures - 10

By: Gilbert E. Andrews/cas
Gilbert E. Andrews
Chief, Appellate Section

cc: William G. DeLana, Esquire
Day, Berry and Howard
1 Constitution Plaza
Hartford, Connecticut 06103

United States Attorney
Hartford, Connticut 06103